

ST 98-9

Tax Type: SALES TAX

Issue: Organizational Exemption from Use Tax (Charitable)

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

TAXPAYER)	
APPLICANT)	
)	
v.)	Sales Tax Exemption
)	Denial
)	
ILLINOIS DEPARTMENT)	Alan I. Marcus
OF REVENUE)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

APPEARANCE: Ms. Michaeline Gordon of Virgil, Berkely & Gordon on behalf of TAXPAYER.

SYNOPSIS: This matter comes on for hearing pursuant to TAXPAYER' (hereinafter the "applicant") protest of the Illinois Department of Revenue's (herein the "Department") denial of applicant's request for tax exempt status for purposes of purchasing tangible personal property free from the imposition of Use and related taxes as set forth in 35 **ILCS** 105/1 *et seq.* At issue is whether applicant qualifies for exemption from such taxes as "a corporation, society, association, foundation or institution organized and operated exclusively for charitable ... purposes" within the meaning of 35 **ILCS** 105/3-5(4).

The controversy arises as follows:

Applicant applied for exempt status via correspondence dated June 28, 1996. (Dept. Group Ex. No. 1). Numerous correspondences ensued but the Department eventually issued a tentative denial on January 7, 1997. Applicant then filed a timely protest and request for hearing on January 24, 1997. (*Id*; Dept. Ex. No. 2). Following submission of all evidence and a careful review of the record, it is recommended that the Department's tentative denial of exemption be affirmed and finalized as issued.

FINDINGS OF FACT:

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, is established by the admission into evidence of the Department's Tentative Denial of Exemption, wherein applicant's request for exempt status was denied. (Dept. Ex. No. 1, Document A).
2. Applicant was originally incorporated under the General Not-For-Profit Corporation Act of Illinois on February 12, 1988. Applicant Ex. No. 3
3. Applicant's original corporate name was "CORPORATE NAME". Its organizational purposes were to: (1) promote assistance in the field of medical health and medical services for individual patients; (2) promote assistance for treatment of sick, injured, afflicted, infirm, disabled or destitute patients; (3) encourage home health services by physicians for those in need; and (4) encourage assistance to those in need by promoting visiting nurses, practical nurses, paramedics and other medical personnel. Applicant Ex. No. 3.

4. CORPORATE NAME was issued a certificate of dissolution or revocation on July 1, 1991 but subsequently re-incorporated under the General Not-For-Profit Corporation Act of Illinois on March 12, 1992. Applicant Ex. No. 4.
5. CORPORATE NAME then changed its corporate name to "TAXPAYER" via Articles of Amendment to its Articles of Incorporation filed on August 19, 1996. Applicant Ex. No. 5.
6. Applicant has no capital stock or shareholders. Its daily business affairs are managed by an uncompensated Board of Directors. Tr. pp. 10-12, 18.
7. Applicant obtained an exemption from federal income tax under Section 501(a) of the Internal Revenue Code in March of 1988. The Internal Revenue Service based this exemption on its conclusion that applicant qualified as an organization described in Section 501(c)(3) of the Internal Revenue Code. Applicant Ex. No. 2.
8. Applicant provides residential treatment, in the form of food, clothing, shelter and counseling, to sexually aggressive children and youth. It provides most of these services pursuant to a contract with the Illinois Department of Children and Family Services (hereinafter "DCFS"). Applicant Ex. No. 1; Tr. p. 21.
9. Applicant also provides therapeutic services (e.g. counseling, etc.) to DCFS referrals on an outpatient basis. Tr. pp. 21- 22.
10. Applicant has a separate contract with Cook County, Illinois (hereinafter "Cook County").¹ This contract provides a secondary source of referrals for inpatient treatment. Tr. pp. 21-22.

1. Applicant did not submit this contract, or its contract with DCFS, into evidence.

11. Applicant has not obtained any referrals for its outpatient program from its contract with Cook County. *Id.*
12. Those obtaining treatment pursuant to these contracts do not pay for any services they receive out of their own funds. Tr. pp. 17-18.
13. Applicant obtains fees for providing these services, as well as most of its other revenue, from its contracts with DCFS and Cook County. Its specific sources of revenue are as follows:

SOURCE	AMOUNT	% OF TOTAL²
Fees from DCFS Contract	\$1,089,826.20	81%
Fees from Cook County Contract	\$ 238,369.53	18%
Fees from Contract for Unspecified Transportation Services with Main School District	\$ 10,926.00	1%
Total	\$1,339,115.73	

Applicant Ex. No. 1.

2. All percentages shown herein are approximations derived by dividing the category of income or expense (e.g. Contributions, etc.) by the appropriate total. Thus, for example, $\$1,089,826.20 / \$1,339,115.73 = .8138$ (rounded to 4 places past the decimal) or approximately 81%.

14. Applicant also incurred the following functional expenses:

SOURCE	AMOUNT	% OF TOTAL
Salaries & Wages	\$ 709,752.00	53%
Payroll Taxes	\$ 67,172.00	5%
Insurance	\$ 82,587.00	6%
Non-Staff Services	\$ 176,598.00	13%
Training & Seminars	\$ 75,963.00	6%
Professional Fees	\$ 15,766.00	1%
Occupancy Expenses	\$ 103,570.00	8%
Supplies	\$ 19,330.00	1%
Office Expenses	\$ 14,656.00	1%
Equipment Rental	\$ 22,372.00	2%
Other Expenses	\$ 24,684.00	2%
Depreciation	\$ 20,145.00	1%
TOTAL	\$1,332,595.00	

Id.

15. Applicant devoted \$1,071,809.00 (or 80%) of its functional expenses to program services. It allocated the remaining \$260,786.00 (or 20%) to general and administrative costs. *Id.*³

CONCLUSIONS OF LAW:

An examination of the record establishes that this applicant has not demonstrated, by the presentation of testimony or through exhibits or argument, evidence sufficient to overcome the Department's *prima facie* case. Accordingly, under the reasoning given below, the determination by the Department that applicant does not qualify for exemption from Use and related taxes as a "corporation, society, association, foundation or institution organized and operated exclusively for charitable ... purposes" within the meaning of 35 ILCS 105/3-5(4) should be affirmed. In support thereof, I make the following conclusions:

3. For detailed breakdowns of the exact amounts allocated to the subgroups that comprise the various categories, (i.e. Director of Nursing expense as composite portion of the salaries and wages allocated to program services), *see*, Applicant Ex. No. 1.

Applicant herein claims the right to an exemption from Use and related sales taxes pursuant to 35 **ILCS** 105/3-5(4), which provides in relevant part that:

Exemptions. Use of the following tangible personal property is exempt from the tax imposed by this Act:

(4) Personal property purchased by a government body, by a corporation, society, association, foundation, or institution organized and operated exclusively for charitable, religious or educational purposes ...[.]

It is well established in Illinois that a statute exempting property or an entity from taxation must be strictly construed against exemption, with all facts construed and debatable questions resolved in favor of taxation. People Ex Rel. Nordland v. Home for the Aged, 40 Ill.2d 91 (1968); Gas Research Institute v. Department of Revenue, 154 Ill. App.3d 430 (1st Dist. 1987). Based on these rules of construction, Illinois courts have placed the burden of proof on the party seeking exemption and have required such party to prove by clear and convincing evidence that it falls within the appropriate statutory exemption. Metropolitan Sanitary District of Greater Chicago v. Rosewell, 133 Ill. App.3d 153 (1st Dist. 1985).

Our courts have not addressed the precise issue raised by this applicant, which is whether a not-for-profit corporation that provides counseling and other services to sexually aggressive children strictly pursuant to contracts with State and municipal authorities, constitutes a "corporation, society, association, foundation, or institution organized and operated exclusively for charitable... purposes ..." within the meaning of 35 **ILCS** 105/3-5(4). Nevertheless, in Yale Club of Chicago v. Department of Revenue, 214 Ill. App.3d 468 (1st Dist. 1991) (hereinafter "Yale"), the court analyzed appellant's claims for educational and religious exemptions under the Retailer's Occupation Tax Act according to the body of case law developed for analysis of property tax exemptions. While the court's analysis of the educational exemption has limited relevance to disposition of the present case, its reliance on Methodist Old People's Home v.

Korzen (hereinafter "Korzen"), 39 Ill.2d 149 (1968) provides the basic framework for analyzing applicant's exemption claim.

In Korzen, the Illinois Supreme Court adopted the following definition of "charity" in analyzing whether appellant's senior citizens home was exempt from real estate taxes under the Revenue Act of 1939:

... a charity is a gift to be applied consistently with existing laws, for the benefit of an indefinite number of persons, persuading them to an educational or religious conviction, for their general welfare - or in some way reducing the burdens of government.

39 Ill.2d at 157 (citing Crerar v. Williams, 145 Ill. 625, 643 (1893)).

The Korzen court also observed that the following "distinctive characteristics" are common to all charitable organizations:

- 1) they have no capital stock or shareholders;
- 2) they earn no profits or dividends, but rather, derive their funds mainly from public and private charity and hold such funds in trust for the objects and purposes expressed in their charters;
- 3) they dispense charity to all who need and apply for it;
- 4) they do not provide gain or profit in a private sense to any person connected with it; and,
- 5) they do not appear to place obstacles of any character in the way of those who need and would avail themselves of the charitable benefits it dispenses.

Id.

Like Section 105/3-5(4), the statute at issue in Korzen used the word "exclusively" to modify "charitable ... purposes." Thus, in applying the above criteria, it must be remembered that "exclusively" means "the primary purpose for which property is used and not any secondary

or incidental purpose."⁴ Korzen, supra at 157. See also, Gas Research Institute v. Department of Revenue, 145 Ill. App. 3d 430 (1st Dist. 1987); Yale, supra; Pontiac Lodge No. 294, A.F. and A.M. v. Department of Revenue, 243 Ill. App. 3d 186 (4th Dist. 1993).

The first step in determining whether an organization is charitable is to consider the provisions of its charter. Morton Temple Association v. Department of Revenue, 158 Ill. App. 3d 794 (3rd Dist. 1987) (hereinafter "MTA"). In making such consideration, it must be remembered that "statements of the agents of an institution and the wording of its governing documents evidencing an intention to [engage in exclusively charitable activity] do not relieve such an institution of the burden of proving that ... [it] actually and factually [engages in such activity]." *Id.* at 796. Therefore, "it is necessary to analyze the activities of the [applicant] in order to determine whether it is a charitable organization as it purports to be in its charter." *Id.*

This applicant's Articles of Incorporation, and the various amendments thereto,⁵ do not contain any specific wording or reference to charity. Illinois courts have, on more than one occasion, indicated that lack of such wording in organizational documents can provide evidence that the applicant is not in fact organized for exempt purposes. People ex rel. Nordlund v. Association of the Winnebago Home for the Aged, 40 Ill.2d 91 (1968); Albion Ruritan Club v. Department of Revenue, 209 Ill. App.3d 914 (5th Dist. 1991). (hereinafter "ARC").

Furthermore, applicant's exemption from federal income tax does not establish that applicant actually operates for exclusively charitable purposes. *Cf.* People ex rel. County Collector v. Hopedale Medical Foundation, 46 Ill.2d 450 (1970). Moreover, while this exemption establishes that applicant is an exempt organization for purposes of the relevant

4. The present case focuses on applicant's operations, not its use of real estate. Thus, it seems appropriate to replace those portions of the above definition which refer to use with language that reflects applicant's primary function as reflected in its organizational documents and actual operations. Any references to secondary or incidental use should likewise be changed to secondary or incidental function.

5. Applicant did not submit its by-laws. Therefore, I must base the analysis of its organizational documents strictly on applicant's Articles of Incorporation and the various amendments thereto admitted as Applicant Ex. Nos. 3, 4, 5.

Sections of the Internal Revenue Code, those sections do not preempt Section 105/3-5(4) or the other statutory provisions governing Illinois Use Tax exemptions. Consequently, neither this exemption, nor the statements contained in taxpayer's organizational documents, are dispositive of its entitlement to exemption from Use and related taxes under Illinois law. Therefore, MTA mandates that any remaining analysis must focus on whether applicant's actual operations fall within the criteria established in Korzen.

Applicant's first, but not exclusive, barrier to exemption under such criteria is that its primary source of funding comes from its contract with DCFS, not "public and private charity." While DCFS is the State governmental agency charged with providing services related to child welfare under 20 ILCS 505/1 *et seq*, applicant obtains all of its funding therefrom pursuant to a contract negotiated at arm's length. Consequently, the revenues generated by this and other contracts⁶ must be attributed to non-exempt business transactions rather than sources specified in Korzen.

Applicant also does not allocate any of the revenues it earns to free care or providing services to persons who were neither referred pursuant to its contract nor able to pay. Rather, the audit (Applicant Ex. No. 1) divulges that applicant applies all such revenues toward funding its internal operations. In this sense, the present matter parallels a line of decisions wherein exemptions were denied because the respective records lacked evidence of any charitable disbursements or supported a conclusion that such expenditures were *de minimus*. Rogers Park Post No. 108 v. Brenza, 8 Ill. 2d 286, 291 (1956), (hereinafter "Rogers Park"); MTA, *supra* at 796; Albion Ruritan Club v. Department of Revenue, 209 Ill. App.3d 914, 919 (5th Dist. 1991); Auburn Park Lodge No. 789 v. Department of Revenue, 95 L 50343 (Circuit Court of Cook

6. The audit submitted as Applicant Ex. No. 1 establishes that applicant also obtained revenue from contracts with Cook County and Main School District. The above rationale (as well as any subsequent reasoning based on applicant's contract with DCFS) applies with equal force to these contracts. However, the DCFS contract provides applicant with approximately 81% of its revenues. Thus, said contract constitutes the primary source of any referrals for applicant's services. (Tr. p. 14). Therefore, I shall place the remaining analysis in the context of applicant's contract with DCFS.

County, September 6, 1996). Based on these holdings, and the preceding considerations, I conclude that applicant's financial structure does not conform to that of an "institution of public charity".

Applicant also fails to satisfy at least two of the other "distinctive characteristics" articulated in Korzen. The fact that it provides services strictly on a contract basis establishes that applicant operates for a limited class of persons. I can not ascertain the precise size of that class because applicant did not submit the actual contract into evidence. However, the testimony of applicant's Executive Director, Robin McGinnis, establishes that applicant does not provide services other than on a contract basis. (Tr. pp. 13-18). Given that this contract inherently limits applicant's capacity to service those not falling within the parameters of its contract, I conclude that applicant neither operates for the "benefit of an indefinite number of persons" nor makes its services available to all "who need and would avail themselves" of same.

Applicant attempts to defeat the preceding analysis by arguing that it removes a burden from the State by providing services that the State would otherwise have to provide itself. (Tr. pp. 15-16). It may be true that DCFS is statutorily mandated to oversee the population applicant serves and ensure the well-being thereof. (See, *supra* at pp. 8-9). However, I must reiterate that applicant provides services to this population pursuant to a contract that resulted from negotiations in the non-exempt commercial marketplace. Hence, applicant's argument is, in all practicality, an assertion that it is relieving the State of a burden merely by doing business with the State.

Our courts have rejected this argument by requiring that applicant's activities benefit the general public rather than a limited class of persons, such as the one that benefits from applicant's contract with DCFS.⁷ As noted above, this contract effectively negates the public

7. For additional analysis of the public benefit requirement and its underlying rationale, *see*, People ex. rel. Brenza v. Turnverein Lincoln, 8 Ill.2d 188, 202-203 (1956); Yale, supra; DuPage County Board of Review v. Joint Commission on Accreditation of Healthcare Organizations, 274 Ill. App.3d 461 (2nd Dist. 1995). For further analysis as to how this and other requirements are used to determine charitable status (or lack thereof), *see*, Korzen, supra.

benefit requirement because it impairs applicant's capacity to provide for those who need its services but do not obtain referrals from DCFS.

This contract also constitutes the *sole* source of fees for the services that applicant *does* provide. Consequently, it is factually impossible for applicant to obtain such fees from any other source, including payments from those who receive its services. Therefore, the fact that applicant provides services without accepting or requiring such payments does not (in itself or in combination with other factors) establish that applicant qualifies as an "institution of public charity" within the meaning of Section 105/3-5(4). For this and all the aforesaid reasons, I conclude that applicant should not be entitled to exempt status even though it engages in many laudable and meritorious endeavors. Rogers Park, *supra*.

WHEREFORE, for the reasons set forth above, it is my recommendation that the Department's Tentative Denial of Exemption be affirmed.

May 28, 1998

Date

Alan I. Marcus
Administrative Law Judge